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STATE FOR EAP/CM AND EEB/IFD/OMA, TREASURY FOR OASIA WINSHIP

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TAGS: ECON EFIN EINV HK
SUBJECT: HONG KONG'S PROPERTY MARKET LOOKS BAD, BUT HK HAS SEEN WORSE

¶1. Summary: Hong Kong's property market dropped sharply in 2008 as sales of all types of building units fell by more than 20 percent from 2007. Property remains an important component of Hong Kong's economy -- for many Hong Kong residents, property is a primary store of wealth, and taxes on property transactions are a major source of government income. Revenues will fall as land sales drop off, but a sizable fiscal surplus from previous years will help cushion the blow. While analysts are not optimistic about the prospects for 2009, most agree that prices will not fall by as much as during 1997-2003 when they dropped by 60 percent. Rising prices for property stocks and a return to more normal transaction levels will be a good indicator that market confidence is returning and Hong Kong's economy is headed for recovery. The Hang Seng Property and Construction Index is down sharply over the last six months, a trend that has continued into 2009, suggesting that optimism is still in short supply. End summary.

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HK Property Transactions Near All-time Lows
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¶2. The global financial crisis is taking a serious toll on Hong Kong's property market. Despite record prices for luxury properties and near-record transaction volumes in the first six months of 2008, both transactions and prices dropped sharply in the second half of the year, leaving the market down over 20 percent for the year. Hong Kong's Land Registry reported 113,298 transactions in 2008, down 22.2 percent from 2007 while the total value of transactions fell by 21.4 percent to HKD 413 billion (US$53 billion). In November 2008, fewer than 3,800 residential and non-residential building units changed hands in Hong Kong, a level not seen since the early 1980s. December transactions were up slightly to 5,437, but still far below the normal range of 8,000-10,000 transactions per month. Local press reports 4,706 properties changed hands through January 22, with less than 10 transactions taking place during the typically slow Lunar New Year holiday (January 24-28). The peak season for the Hong Kong property market is normally the two months after the Lunar New Year.

¶3. After luxury property prices hit record levels in the first half of 2008, prices for all classes of property have fallen sharply. Prices for luxury properties (over 160 square meters/1440 sq. feet) have fallen by 40-50 percent, while even the smallest apartments (under 40 sq. m/400 sq. ft.) have seen prices drop by 15 percent. Rents for residential and commercial property are also beginning to fall.

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Falling Prices Mean Falling Revenues for HKG
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¶4. The fall in transaction volumes and prices is bad news for the Hong Kong Government (HKG), which relies on stamp duties on property transactions for a significant part of its revenues. The Hong Kong government owns all land in Hong Kong, but issues tradable leases which can extend for long periods, typically 75-99 years, and are normally renewable. The government then charges duties on property sales and zoning conversions. In past years, stamp duties on property transactions have accounted for as much as 30 percent of total government income but land sale reforms implemented in 2004 to restrict the supply of new property on the market make it unlikely that stamp duty income will account for such a large percentage of government revenue in the future. In FY2007-8, revenue from all stamp duties, including both equity and property sales, was HKD 50 billion (US$6.4 billion) and accounted for approximately 17 percent of total government revenue. Hong Kong's 2008-9 fiscal year will end on March 31, 2009 and will include several months of buoyant property transactions, mitigating the negative impact on government revenues for this year. Hong Kong will also benefit from the accumulation of large fiscal surpluses over the past several years, making it relatively well positioned to carry out ambitious plans to increase government spending on infrastructure and social programs in the next two years.

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Bad Market, but Hong Kong has seen Worse
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¶5. As difficult as the current market may be for homeowners and the government, prices have not yet fallen as much as

they did in 1996-1997. At that time, the confluence of a bursting property bubble, a regional financial crisis, and government policies that encouraged additional building even as the market slipped forced Hong Kong property prices down by 60 percent for all classes of property. Many mortgage holders ended up owing far more on their property than its current valuation. Despite large numbers of home buyers ending up "under water," default rates in the post-97 period in Hong Kong were extremely low - less than three percent at the peak. Observers attribute this low default rate to the high down payment requirement (30 percent) for most mortgage holders, cultural norms that discourage default, and the existence of family and community support networks to help home owners make their payments. Ten years later, these same factors are likely to keep Hong Kong's non-performing property loans to a minimum. The dream of home ownership remains strong in Hong Kong. Sixty percent of Hong Kong residents live in their own privately owned property. Thirty percent still live in public housing, while the remaining ten percent rent from private landlords, according to Shih Wing-ching, Chairman of Hong Kong's largest real estate agency, Centaline. For many in Hong Kong, their home is their primary investment, he said.

¶6. Analysts agree that the current fall in property prices is unlikely to be as bad as the late-90's in part because low and mid-range property prices never reclaimed the lofty heights of that bubble. Developers also have insulated themselves from the decline in housing prices. Ten years ago, many property developers in Hong Kong were highly leveraged and were forced to put properties on the market for any price, just to generate cash flow. Today, the major developers in Hong Kong have much lower gearing ratios (i.e., less debt) and have diversified into rental and commercial properties that generate a healthy stream of income. The HKG's application list system, which requires property developers to file an application to develop a parcel of land and then win the rights at auction, slows the pace of new properties coming on line, keeping supply tight and property prices high. In addition, Hong Kong developers have expanded into projects in other economies, including mainland China, where they have applied the lessons of low gearing and

diversified income streams learned during the Asian Financial Crisis. Hong Kong analysts expect Hong Kong property developers will fare better in China than their Chinese counterparts, many of whom are reportedly highly leveraged.

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Property Indicator Suggests Shorting Optimism
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¶7. Hong Kong asset prices are historically extremely volatile, in part due to the open nature of its economy and the Hong Kong dollar's link to the U.S. dollar, which forces Hong Kong to adopt interest rates closely aligned to U.S. rates. Low U.S. interest rates can quickly lead to bubbles in Hong Kong. Local property bubbles have historically tended to be supply driven, said CLSA Property Analyst Aaron Fischer. As prices increase, developers tend to rush into the market. In the past, the government has quickly released land for development, resulting in oversupply and falling prices. In contrast, the current downturn is demand driven, he said. The application list process has limited the supply of new properties on the market to just about 10,000 per year, as compared to 25,000-30,000 per year in the late-90's. Given the nature of the current property slowdown, there is little the Hong Kong government can or should do, he said. When consumer confidence returns, property prices will recover rapidly, said Fischer.

¶8. Both prices and transactions can be an accurate, if lagging, gauge of market sentiment in Hong Kong, according to LIM Advisors Director Peter Churchouse. Both will respond to changing sentiment, however, property stocks are an even better indicator and can be expected to respond quickly to increased optimism, said. The Hang Seng Property and Construction Index is down 45 percent over the last six months and ten percent for the year so far, suggesting that optimism is still in short supply.
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